

Is Commercialization of Microfinance Responsible for Over-Indebtedness? The Case of Andhra Pradesh Crisis

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Abstract

The main purpose of this theoretical study is to analyze whether commercialization of microfinance institutions (MFIs) is responsible for over-indebting their poor borrowers taking into account the recent Andhra Pradesh (AP) incidence. Critics argue that massive influx of commercial capital cause exponential growth of loan portfolios of the MFIs that finally cause over-indebtedness. The diagnosis of AP incidence indicates that commercialization is not solely and directly responsible for over-indebting their clients. It is the outcome of internal inefficiencies, unethical operations and malpractices of MFIs. However, commercialization is indirectly responsible for over-indebtedness when 'profit seeking' MFIs start unethical practices to maximize their profit. This issue is important not only for India but also in some other developing countries to ensure sustainability of MFIs and to protect their poor clients.

Keywords: Microfinance; commercialization; over-indebtedness; AP crisis.

JEL Classification: G21, O17

1. Introduction

Immense public recognition of microfinance for its social orientation and fighting against poverty is now facing increasing criticism and public attention due to its allegation of exploiting and over-indebting its clients. The benefit of microfinance is now an illusion. M. Yunus's (2006) claim of microcredit as human right¹ is now in question especially after the 2010 Andhra Pradesh over-indebted microfinance borrowers' suicides². Commercialization of microfinance institutions (MFIs) are sometimes alleged for over-indebting their poor borrowers. Critics argue that massive influx of capital from shareholders, commercial banks, international and private investors cause exponential growth of loan portfolios of MFIs that finally push the whole sector as an ideal breeding ground of over-indebtedness (Taylor, 2011; Mader, 2013; Wichterisc, 2012). Trade liberalization, state retrenchment of formal banking sector, and agricultural transformation in India infused MFIs as a lucrative private sector offering high and attractive profit to investors. It endangers social impact and the industry sustainability (Hudon, 2009); cause exploitations, economic, social and psychological pressure to borrowers and results the worst scenario as claimed in media: suicide and prostitution (Guerin et al, 2009a; Mader, 2013; Taylor, 2011).

However, commercialization of microfinance is the strategy to accumulate funds when subsidy from donors and charities ceases to exist for a long time. But commercialization translated into deluge of funds for investment in MFIs, caused huge market penetration, market saturation, multiple lending and over lending; and finally, over-indebting their clients. The crisis in Andhra Pradesh is the worst case of this allegation. It happened not only in India but also in many other developing countries of the world such as Bosnia, Herzegovina, Morocco, Pakistan, Bolivia and Nicaragua with different dimensions and experiences (Olteanu, 2011). But we cannot avoid commercialization in the absence of subsidy and donor support as investors will not provide funds without financial incentives. At this moment, it is important to justify whether commercialization of microfinance is responsible for their clients' over-indebtedness and if so, to what extent and in what way it is responsible; or whether it is the outcome of unethical practices of MFIs or some other factors rather than commercialization. This theoretical study tries to find out the answer of these questions.

The main objective of this paper is to study whether commercialization of microfinance institutions (MFIs) is responsible for over-indebting their poor borrowers taking into account the Andhra Pradesh crisis. The main research questions are: whether over-indebtedness is the outcome of unethical and malpractice of profit hunger

¹ Speech at the Nobel Peace Prize Ceremony at Oslo, Norway: he mentioned microfinance as the tool to establish peace by fighting against poverty and treated microcredit as human right. Source: http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-lecture-en.html (Date: December 10, 2006).

² See Yoolim Lee & Ruth David: Suicides in India Revealing How Men Made a Mess of Microcredit. Bloomberg Market Magazine (December 28, 2010) <http://www.bloomberg.com/news/2010-12-28/suicides-among-borrowers-in-india-show-how-men-made-a-mess-of-microcredit.html>

commercialized microfinance institutions? What is the extent of this conviction? Or is it the outcome of some other factors? What counter-mechanism and policy implications are necessary to overcome this crisis? Result of the Andhra Pradesh diagnosis indicates that commercialization is not solely and directly responsible for over-indebting their clients. It is the outcome of internal inefficiencies and unethical practices of MFIs and some other external factors. The analysis, however, indicates that commercialization is indirectly responsible for over-indebtedness when commercial investments in these ‘profit seeking’, MFIs caused huge market penetration, multiple lending and over lending through some unethical practices.

I presented the rest of this paper as follow: section two is theoretical background and literature review, section three is the diagnosis of Andhra Pradesh crisis, section four is the discussion and justification whether commercialization is responsible or not, section five discusses management consequences, section six is the recommendation, policy implications and limitations and finally section seven is conclusion.

2. Theoretical Background and Literature Review

Commercialization generally means the MFI’s seeking to operate with commercial sources of funding following market based business principles and without direct or indirect subsidy elements in its funding structure (Armendariz and Morduch, 2010). It indicates leveraging interest revenues, mobilizing savings deposits¹ and the ability of the MFIs to distribute profits to their shareholders that helps the MFIs to access vast pool of capital. Armendariz and Morduch (2010) treated commercialization as a ‘win-win’ situation by adopting commercial principles and practices in fighting against poverty. However, seeking profit by serving the poor in this way has fear of ‘mission drift’ due to the trade-off between profitability and outreach to the poor (Morduch, 2000; Armendariz and Szafarz, 2011). The background of the spirit of commercialization approach of MFIs is on Max Weber’s proposition of ‘ethics of responsibility’, where as, M. Younus and many other critics’ view commercialization as the ‘ethics of conviction’ (Schmidth, 2012). The first one is the urgency of microfinance institutions for its sustainability and social orientation. The evil side is when MFIs commercialization is alleged for ‘ethics of conviction’.

Over-indebtedness is the outcome of the ‘ethics of conviction’ of MFIs (Schmidth, 2012). Canner and Luckett (1991) treat over-indebtedness when the debt problems are structural and persistent over a certain time horizon. Oiko Credit defines over-indebtedness when a client cannot repay the loan more than three months (Gravestijn et al, 2011). Schicks (2013) defines over-indebtedness from client sacrifice perspective when a customer continuously struggle to meet repayment deadlines and has to make undue sacrifice related to his/her loan obligations that has more than transitory effects. Some researchers and practitioners measure it as the net indebtedness index² (Betti et al., 2007), debt service ratio (Collins 2008), legally bankrupt borrowers or delinquency/default/arrear ratio (Disney et al, 2008; Kappel et al., 2010); others measure it as the perception of debt burden (Lea et al, 1993; Guerin et al, 2009b). However, according to Guerin et al. (2009b) the consideration of only default or debt burden is not suitable to measure over-indebtedness in developing countries. It can result in either inability to repay or unwillingness and costly actions required to repay (Gonzalez, 2008; Schicks, 2013). However, these definitions and measurements exclude those borrowers who do repay their loans by making strategic sacrifice or assisted by family members to repay their loan (Gravestijn et al, 2011). It also excludes the borrowers who strategically default or deliberately accumulate unsustainable amount of debt (Schicks, 2013).

The causes, factors behind and consequences of commercialization of microfinance are discussed by Babri et al. (2010), Carrilo (2009), Chasmar (2009) and Schmidth (2012). Sriram (2010a) discussed commercialization of microfinance from Indian context. The literature on Andhra Pradesh microfinance crisis, extent of microfinance commercialization, clients’ over-indebtedness, factors and causes related to over-indebtedness in India till to date are Reddy (2010), Mader (2013), Kumar (2012), Wichterich (2012), Arunachalam (2011), Schmidt (2010), Nair (2011), Taylor (2011), Ghate (2007b), Picherit (2009), Guerin et al. (2009a) and Joseph (2012). The other studies on over-indebtedness in other parts of the world are: Morvant-Roux (2009) on Mexico; Olteanu (2011) on Peru; Burki (2009) on Panjab province in Pakistan; Pytkowska and Spannuth (2011) on Kosovo; Maurer and Pytkowska (2011) on Bosnia and Herzegovina; Schicks (2013) on Ghana; Khalily and Faridi (2011) on Bangladesh; Rhyne (2001), Vogelgesang (2003), Gonzalez (2008), Gonzalez-Vega and Villafani-Ibarnegaray (2011) on Bolivia crisis 1999-2000, and Hurwitz and Luiz (2007) on South African context. The detail of the findings is not possible to discuss in this limited space. However, there is hardly any study found that empirically and theoretically discussed whether commercialization of microfinance causes over-indebting their clients; majority of them indirectly claimed commercialization for this crisis. This paper is a step towards to explore this critical debate.

¹ If regulation in the country permits savings

² debt service payment in relation to net income

3. A Diagnosis of the Commercialization and Microfinance Crisis in Andhra Pradesh

The recent example of microfinance commercialization is Andhra Pradesh, a southern state of India. Microfinance operation in this 'hub' began in 1980s in small scale as NGO driven MFIs. But due to the state drive as the 'priority sector' and the World Bank funding in 1990s, it underwent expansion and commercialization (Taylor, 2011). Trade liberalization, state retrenchment of formal banking sector and transformation in the agricultural sector facilitate livelihood diversification. It bolstered MFIs as the new breed of private sector offering attractive profit to investors. Massive influx of capital from shareholders, commercial banks, and international and private investors cause exponential growth of loan portfolios of MFIs that finally push the whole state as an ideal breeding ground of debt dependency and over-indebtedness of the poor households (Mader, 2013; Taylor, 2011).

3. 1. Krishna District: The First Warning of the Crisis

The first warning of the crisis was in 2006 at Krishna district of Andhra Pradesh. It started by borrowers' demonstration to back (return) their house title (deed) that had been seized as collateral and it turned into violent protest. At that time MFIs were alleged for 200 suicides and repayment rate went down around 10% to 20% for several months (Ghate, 2006 & 2007a; Sharma, 2006). As a consequence, the state government temporarily closed 50 MFI offices of *Spandana Spoorthy* and *SHARE Microfinance* (Mader, 2013). However, these MFIs have denied their allegation of wrong doing; rather claimed that state lending program, *Self Help Group* (SHG) has acted as enabling factor in the crisis (Mader, 2013; Ghate, 2007b).

3. 2. The Microfinance Bubble

In India, during 1990s, thousands of microfinance institutions and non-banking finance companies acted as intermediaries between the women borrowers at marginal level and the commercial banks. They took loan from Indian and foreign banks at usual interest rate to bolster their capital and guarantee liquidity; then re-lend it to poor women and households at usurious interest rates and charges (Wichterich, 2012). Turning this credit-lending process into market mechanized profit making sector, MFIs have established as an attractive sector of handsome return from investment (Mader, 2013). The number of MFIs soared to above 3,000 within a decade (Wichterich, 2012). After the Krishna incidence, rather than halting the inflow of capital, the trend continued for its typical prospects of attractive return. The investment funds (MIVs) geared this fastest growing segment articulated by penetration into financially excluded segment of Indian population that was impressed for high rate of repayments and widespread outreach, gender equality and articulated success stories. The promise of double digit return on their investment, widespread belief of microcredit as the panacea to reduce poverty, empowering women, and promoting small entrepreneurship fulfilled the bankers' and investors' need to make attractive profit with social orientation (Taylor, 2011; Wichterich, 2012; Mader, 2013).

In this microfinance investment mania, equity infusion drove a rapid growth in lending; six leading MFIs attracted 80% of investment and it caused an annual portfolio growth of 89% between March 2006 and March 2010 (Mader, 2013). The commercial injection of investment changed a herd of highly ambitious 'young turk' (Greenfield) MFIs, which were making losses, surprisingly become profitable (Parameshwar et al., 2010; Mader, 2013). In 2007-2008, *SKS*, the largest MFI in India, rose net profit by 700% and the second largest MFI, *Spandana Spoorthy*, increased net profit by 1,700% (Nair, 2010; Wichterich, 2012). In 2008-2009, they confirmed increase of 60% clients from previous year, reached 8.5 million female clients with approximately 8 billion US dollar (360 billion rupees) loan portfolios (Srinivasan, 2010; Wichterich, 2012). The immense loan factory in Andhra Pradesh accounted just around 30% of India's total loan portfolio despite only 7% of the total Indian population in that state (Srinivasan, 2010; Mader, 2013). The industry shown an immensely profitable sector with an average return on equity (ROE) of 27.5% in 2008 and 25% in 2009; the 10 largest MFIs even earned on average 37.8% and 35.2% in 2008 and 2009 respectively (Mader, 2013). This extraordinary return fueled private capital; loan portfolio stood around 2.7 billion US dollar among these six leading MFIs with an annual compound growth of 89% (Arunachalam, 2011; Mader, 2013).

3. 3. SKS: The Lynchpin in the Bubble

SKS was at the frontline of the Andhra Pradesh microfinance boom. *SKS* started its business in 1997 by Indian-American 'social entrepreneur' *Vikram Akula* as a non-profit NGO, but transformed into Non-bank Finance Corporation (NBFC) in 2005. By 2007, it has become the largest profitable MFI in India (Mader, 2013). Due to its illusive growth and lucrative financial profit, *Sequoia Capital*, an American venture capital fund, invested in 23.6% of its equity with the aim of 'exit with profit' through share issue in stock market (Mader, 2013). Commercial banks also took opportunity to lend them as a safe bet profitable 'priority sector'¹. A deal of

¹ Please see Rediff Business. 2004. Banks take the hint, to step up farm loans. Rediff Business, Mumbai, May 28. Available at: <http://inhome.rediff.com/money/2004/may/28spec.htm>.

microloan securitization of 42.6 billion US dollar was made between SKS and ICICI Bank¹. These capital injections fueled its portfolio growth. In July 2010, its IPO went forward in Mumbai Stock Exchange with approximately 1.5 billion US dollar, an over subscription of more than 13 times; the company valued at nearly 40 times of its 2010 earnings (Mader, 2013). This IPO raised US \$ 358 million rising stock price for over following six weeks².

However, the controversy to this IPO arose when the Seattle based NGO unit announced to sale all its shares in SKS for 70-80 million US dollar to exit its microfinance investment (Rajshekhkar & Grenny, 2010; Mader, 2013) to earn profit from IPO. The director (Mr. Akula) sold his 13 million US dollar worth private shares to a hedge fund in Singapore that fueled this controversy and it reinforced accusation of 'personal enrichment at the expense of poor women' (Wichterich, 2012). Arunachalam's (2011) examination of SKS Balance Sheet found that Mr. Akula owned these shares by borrowing roughly 350,000 US dollar from SKS to buy at 10 Rupees per share, a discount of nearly 99% against the IPO price. It raised ethical question whether commercialized MFI is a club of rich investors seeking to 'cash in' on poor borrowers making them poorer and over-indebted.

4. Commercialization of MFIs and Over-indebtedness

4.1. Commercialization of MFIs: Extent of Conviction

The neo-liberal reform (Bateman, 2010) in the economy opened the door to transform NGO type MFIs into 'profit seeking', MFIs driven by commercial funding as their main sources of capital (Wichterich, 2012; Taylor, 2011). This has driven the influx of commercial investment in MFIs (Taylor, 2011). Again it influenced some of the MFIs to change their funding pattern from 'loan for investment' to 'share capital for investment' by entering into formal capital market (Taylor, 2011; Mader, 2013). Critics argue that it translated into deluge of funds for investment in MFIs, caused huge market penetration, market saturation, multiple lending and over lending, and as a result, over-indebting their clients. This section outlines whether commercialization of microfinance is responsible for their clients' over-indebtedness and if so, to what extent and in what way it is responsible.

Deluge of capital induced irrational growth, market saturation and competition: At the pinnacle of the factors responsible for the crisis was the exponential and irrational growth of loan portfolio due to huge commercial fund injection in these MFIs. By March 2010, 35.9% of all households in Andhra Pradesh had MFI loan (Mader, 2013). To re-lend this capital, MFIs used every possible angle in the client acquisition process (Arunachalam, 2011). The average loan balance per borrower was more than doubled and compounded by multiple lending (Mader, 2013). It result indebting of 82% of the rural households in the region (Wichterich, 2012). Commercialization of microfinance in this area caused competition and the market became saturated. Despite the default rate increased, MFIs have hide it by 'rolling over'³, the loans replacing the non-performing loans by rescheduling it (Mader, 2013).

It caused their clients multiple borrowing and loan juggling (i.e. using new loan to pay back the old debt) (Mader, 2013; Taylor, 2011; Wichterich, 2012; Rhyne, 2001; Burki, 2009). In Andhra Pradesh, it caused growth of loan portfolio of between 64% and 98% each year (Mader, 2013). About 84% of the households obtained two or more loans while 58% even had four or more loans (Johnson and Meka, 2010). It result 1.5 loans per household in the whole state of Andhra Pradesh (Srinivasan, 2010).

This situation is not only in AP. In Morocco, 10 reporting MFIs reporting in MIX Market also experienced the same situation. There was 110% growth of loan portfolio with the highest 330% by the fastest growing MFI, ARDI in the 2006-07 crises (Schicks, 2013). This situation is also true in some other developing countries such as Bolivia and Mexico for creating their clients over-indebted (Rhyne, 2001; Carrillo, 2009; Gonzalez, 2008).

Coercion and home made inefficiency: Home made inefficiency of MFIs (Chowdri, 2011) and quantity based incentive mechanism to loan officers and agents to inflate their loan portfolio resulted in greater market penetration and loss of credit discipline. They started client poaching, snatching customers from each other, and even encouraged very poor households to borrow without considering repayment capacities (Wichterich, 2012; Burki, 2009). It was almost impossible for an agent to 'know customers' due to dealing with around 500 customers on average (MIX Market database). This loss of credit discipline (Chen et al, 2010) put their clients into debt trap (Sriram, 2010).

This situation is true not only in Andhra Pradesh, but also in some other countries like Pakistan (Burki, 2009)

¹India Microfinance (2009), SKS Microfinance and ICICI bank conclude securitization deal. India Microfinance Business News, February 19, 2009. Available at: <http://indiamicrofinance.com/sks-microfinance-icici-bank-conclude-securitisation-deal.html>.

² The Economic Times, August 17, 2010 SKS Microfinance debuts at 11% premium. Available at: http://articles.economictimes.indiatimes.com/2010-08-17/news/27599524_1_sks-shares-listing-gains-sks-microfinance.

³ David R. 2010. Threat of microfinance defaults rise in India as SKS plans IPO. Bloomberg, New York City, June 14, 2010. Available at: <http://www.bloomberg.com/news/2010-06-14/india-microfinance-evokes-risk-of-subprime-in-the-east-as-sks-prepares-ipo.html>.

and Bolivia (Rhyne, 2001). Moreover, SKS offered attractive salaries and incentives to their staffs working at the village and semi-urban areas than that of their peers (Mader, 2013). This lucrative incentive mechanism influenced them to collect as many clients as possible causing to take multiple loans by same client.

Exorbitant interest rate: Commercial MFIs charge usurious interest rate to poor clients to ensure their profits at the expense of putting their clients into debt trap. Although researchers argue that microfinance borrowers earn super-normal profit than that of a corporation to repay their loan with all charges, they always cannot earn sufficient profit (return) to repay their loans. An ethnographic analysis from Bolivia by Brett (2006) reveals that most micro-enterprises in their local context do not earn sufficient profit to repay their loans.

Compartamo's interest rate is around 100%; and without VAT (value added tax) it stands to 86% per annum (Rhyne and Guimon, 2007). This rate ensures its high profit that helps to attract commercial funds. Astha (2009) shows that effective annual rate (EAR) of *Compartamos* reached to 119%. The Andhra Pradesh MFIs also earned above 60% annual effective rate but they disclosed only 24%-28% annual rate (nominal rate) in public (Mader, 2013).

The above discussion and the diagnosis of Andhra Pradesh incidence make it clear that commercialization can be a catalyst in over-indebting their clients, not directly responsible for over-indebtedness. The main cause was their greedy mentality following some unethical practices to support their irrational and unhealthy growth targets where commercialization was the catalyst.

4. 2. Other Factors behind Over-indebtedness

We cannot convict commercialization alone responsible for the microfinance players to initiate and expedite unethical practices. Some other factors are also responsible for over-indebtedness. However, some of these factors are also influenced by commercialization.

State of the agrarian economy: The majority of the poor people in India are dependent on agriculture. But agriculture is vulnerable to climatic conditions such as droughts, rainfall and floods etc. The agricultural smallholders in recent years have shifted towards cultivating cash crops (non food grain items) such as ground nuts, cotton and used hybrid seeds (Rao and Suri, 2006; Garikipati, 2008; Vasavi, 2010, Taylor, 2011). High input prices, fluctuation in market price and production fluctuations (drop in production) due to droughts in this semi-arid region in the last few years aggravated their situations; they have taken more loans, again invested it in agriculture without realizing any substantial returns (Taylor, 2011; Galab et al, 2009). This irregular cycle of agrarian cash flows spurred debt traps in the absences of alternative income generating activities (Garikipati, 2008 & 2009).

India's long tradition of debt dependency: According to Malcolm Darling (1925, stated by Taylor, 2011), the Indian peasants are born in debt, live in debt and die in debt. Surprisingly, this statement is true to smallholders and landless laborers when there is around 250,000 suicidal death from 1995 to 2010¹ (Sainath, 2010; Taylor, 2011). According to Taylor (2011), Galab et al (2009) and Sainath (2010)², the Andhra Pradesh is in the leading state of suicidal incidence with 1,098 farmers from May 2004 to November 2005 and it peaked at 2,414 deaths in 2009.

The land-poor farmers and landless laborers are the largest social classes in agrarian India, and they have experienced increased insecurity in their ability to meet household needs (Rao and Suri, 2006). Changes in agricultural pattern have greatly amplified their insecurity due to changing crop prices; exploitative contracts for land rent and inputs, unpredictable climatic condition and quality of off farm activities put them into risky position (Jodha, 2008; Breman, 2007; Harris-White, 2008; Taylor, 2011). A number of such overlapping processes escalate pressure on marginal cultivators and landless laborers to put them into debt traps. Commercialization of microfinance in this case, thereby, fueled to renew the cycle of indebtedness. But the fundamental cause of the crisis lies with India's historical tradition of abusing debt (Taylor, 2011).

Inappropriate product design: The product design itself without considering clients' ability to repay (Schicks, 2013) and ability to generate cash flow is another problem that fueled the crisis. In the Indian agrarian economy, the repayment starts immediately after loan disbursement and installments are frequent throughout the whole loan tenure irrespective of the farmers' harvest time to realize cash. This income seasonality caused further borrowing from informal sources (Taylor, 2011; Gokhle, 2009).

Again, credit to women only makes another problem of grabbing it by their husbands in these male dominated societies. It put these women at risk of over-indebtedness as they lost their control on debt use (Brett, 2006; Rahman, 1999; Schicks, 2013).

Absence of Savings Mechanism: Credit only approach is not panacea for clients. State regulation in some countries does not authorize savings (Mader, 2013; Taylor, 2011). This is true in Bolivian and Mexican case also. In the absence of savings, MFIs lost their low cost source of funds on the one hand, and, borrowers lost their

¹ Sainath, P. 2010. Of Luxury Cars and Lowly Tractors. *The Hindu*, 27 December.

² Sainath, P. 2010. 17,368 Farm Suicides in 2009. *The Hindu*, 27 December.

opportunities to consumption smoothing, meeting emergency needs and pay big sum expenditures on the other hand (Collins et al, 2009). It causes the borrowers to cope with shocks and increase dependency on debt, hence lost their opportunity to self discipline (Armendariz and Morduch, 2010). MFIs also lost their opportunity to use savings as collateral (Armendariz and Morduch, 2010).

Unproductive credit use: Within Andhra Pradesh, microloan usage was mainly for consumption smoothing, covering health related expenditures, costs of wedding, dowries and other social events (Rao, 2005; Samal, 2006; Taylor, 2011; Ramachandran et al, 2010). Only a quarter of the loans were used for productive purpose particularly for agricultural inputs and one fifth was used to repay the old debt (Srinivasan, 2010; Taylor, 2011). This pattern varies greatly according to socio-economic classes and castes. The low caste groups mostly use credit for meeting their basic consumption needs or paying existing debts (Taylor, 2011). This use of loan to smooth consumption¹ (Rhyne, 2001; Bateman, 2010) may temporarily overcome external shocks (Rosenberg, 2010), but do not help in generating return and alleviating poverty rather than putting them into 'debt trap'.

Informal borrowing: Moreover, households' borrowing from a variety of formal and informal sources² worsened the situation. In Southern India including Andhra Pradesh, some rich and upper castes obtained loan from banks and MFIs, lend it to poor households at easy conditions but higher interest rate, and it fueled in multiple borrowing and debt trap (Taylor, 2011; Mader, 2013). It cause debt bondage and attached labor (Guerine et al, 2009a; Mader, 2013). Particularly to agricultural workers and marginal farmers in semi-arid India, it is common when production falls and cannot recover the costs of cultivation (Gorikipati, 2009; Olsen and Ramanamurphy, 2000).

State intervention and SHG program: The design of state sponsored SHG program also fueled in this race. Srinivasan (2010) estimated that the total number of microfinance clients in Andhra Pradesh was 25.36 million of whom SHG program alone accounts for 19.11 million clients. It caused market saturation, taking multiple loans to cover repayment schedules and overlapping of about 10% between MFIs and SHGs (Taylor, 2011). Moreover some MFIs claim that AP government intervention acted as enabling factor in the crisis (Mader, 2013). Rao (2008) mentioned SHG program in this battle to monopolize the poor.

Staff and group pressure to committing suicide: To recover the default loan, sometimes the field officers and agents influenced and pressed clients to commit suicide to recover the loan due from credit life insurance (Mader, 2013). On the other hand, MFI staffs also claimed that group members influenced the over-indebted client to commit suicide to avoid group repayment of the defaulted loan.

However, a subsequent investigation by Ashta et al (2011) across different states of India found positive but insignificant correlation between microfinance penetration and suicidal cases. However, it found stronger and significant correlation between SHG penetration and suicidal cases. Moreover, in all the states, it found positive association of microfinance penetration with male suicides, not female suicides; but majority of microfinance clients are female. It indicates that rather than microfinance, agricultural production fluctuation and other household uncertainties are mainly responsible in their suicides.

5. Consequences of over indebtedness

Though commercialization of MFIs allows entering into large pool of funds to support their portfolio growth, it is a great concern for management from risk management and customer protection perspective when it increases the probability of their clients' over-indebtedness. Over-indebtedness is a threat to profitability and sustainability of MFIs when it results delinquency and deterioration of portfolio quality. Chen et al. (2010) found that over-indebtedness increase portfolio at risk (PaR) around 7% in Bosnia, 12% in Nicaragua, 10% in Morocco and 13% in Pakistan. It requires higher loan loss provisions (Schicks, 2013), and then write-off finally causes permanent loss of portfolio. Other consequences are higher screening, collection and operating costs in dealing with over-indebted customers (Canner and Luckett, 1991). Collection of default debt challenges organizational identity, it causes shrinking their operations and results in portfolio losses and retrenchment; loan officers and other employees may loss their job, cause lower staff morale, and make bad impression on good borrowers. It weakens MFIs, put them at risk, create instability, and put their other operations and even savings at risk (Schicks, 2013; Burton, 2008). The crisis in Andhra Pradesh and Bolivia is the evidence of this situation (Rhyne, 2001; Gonzalez, 2008; Wichterich, 2012; Mader, 2013). In Andhra Pradesh, the overall loan portfolio shrunk from US \$ 5.4 billion in 2010 to US \$ 4.3 billion in 2011 with decline in number of clients borrowing from 32.5 million to 26.4 million (Mader, 2013).

Over-indebtedness, in this case, not only harms the poor clients, but also causes the investors to lose confidence in MFIs when the MFIs make losses, crunch their liquidity, and suffers negative growth. It makes difficulties for the MFIs to find new capital and their share prices in the market fall. So, it not only cause problem to these

¹ This case is also true for Bolivian crisis (1999-2000).

² Village money lenders played a big role in this case.

troubled MFIs, but also spillover in another MFIs, put the whole industry in question (Gonzalez, 2008; Wichterich, 2012; Mader, 2013; Schicks, 2013). Over-indebtedness in these problem MFIs put their public reputation in question, accuse political interference, media criticism and ultimately government may take drastic action against MFIs to restrictive regulation. In Andhra Pradesh, government closed some MFI branches for this allegation (Taylor, 2011; Mader, 2013).

Over-indebtedness also worsens borrowers' socio-economic and psychological situations rather than improving their living condition from debt use. Guerin et al. (2009a) treated microfinance as the 'double edged sword'; it can either reduce financial vulnerability or push the households further into debt. It contradicts social mission of microfinance, exacerbate poverty level of borrowers, threaten their social and economic position, and push them into mental and psychological disorders (Schicks, 2013). It causes borrowers to reduce their consumption, sale of income generating assets, stop their children from school (Schicks, 2013). The extreme form of this evil act is bonded labor or slavery¹, suicide², sexual harassment and prostitution when they fail to repay the loan in due time (Churchill and Guerin, 2004; Picherit, 2009). It may threaten MFI sustainability by triggering delinquency and default (Burki, 2009; Rhyne, 2001; Schicks, 2013). Finally it causes 'mission drift'. Management need to acknowledge it in due time and need to take proper action before occurring 'disaster'.

6. Recommendations, Policy Implications and Limitations

6.1. Recommendations & Policy Implications

However, the allegation of over-indebting poor clients, partly fueled by commercialization, are need to control or eliminate to ensure dual mission, sound and healthy operation and fair competition that can benefit both the MFIs and their poor clients. At the core of the crisis, the following three areas of actions are necessary to implement so that it may not happen again in the future.

6.1.1. For the MFIs: Industry self regulation

Self regulation of microfinance industry is very important in an informal economy especially in countries with limited state regulation and supervision (McKee et al, 2011). This is possible in different dimensions that are discussed below.

- a. *Follow client protection principles*: Client protection principles, introduced by Smart Campaign, are important to implement to enhance credibility of MFIs in providing financial services to the poor (Arguello et al, 2013; Ghate, 2007a). The most important principles to eliminate any coercive action and to overcome the crisis are:
 - i) *Develop an appropriate product design and delivery mechanism* so that clients do not need to sacrifice in repayment on the one hand and meet their funding needs on the other hand. Determination of appropriate amount of credit, flexible and suitable installment system matching with their cash flows, option of both group and individual loan, repayment options convenient with their capacities are important to consider in this case.
 - ii) *Ensure Responsible pricing* such as interest, commissions and fees charged to their clients are important both from MFI sustainability, and social and ethical viewpoint (Arguello et al, 2013). Rather than charging high margin in fixing interest rate³ to pay interests and dividends to investors and shareholders, controlling operating costs by increasing their efficiency in operation help the MFIs to protect their poor clients from over-indebtedness.
 - iii) *Maintain transparency and disclose price related information* to ensure that borrowers are well informed about loan amount, installments, fees, charges, repayment systems and loan durations that can eliminate coercive actions, and facilitate clients' informed decisions. Clearly inform the effective annual rate (EAR) and APR, and penalty to be charged in failure to repay in due time (Arguello et al, 2013). MFIs can disclose it in a big poster or screen so that everyone can see, understand and aware of it⁴.
 - iv) *Fair and respectful client treatment / code of conduct*: The Bolivia and Andhra Pradesh crisis blamed that MFI agents and loan officers have not respected their clients' ability to repay the loan. Building strong relationship with clients, understanding their situations, developing mutual trust, exploring and implementing repayment options and agreeing on solutions can redress client grievance, solve conflict and help to recover loan overdue (McKee et al, 2011) than harassment and pressure to commit suicide.

¹ When the borrowers obtain loan from local moneylenders to repay the old loan of MFI at usurious rate, they have to work for more for the moneylenders as a condition to repay the loan when they are not able to repay the loan.

² Conviction of suicide in Andhra Pradesh, India, please see one story: <http://www.bloomberg.com/news/2010-12-28/suicides-among-borrowers-in-india-show-how-men-made-a-mess-of-microcredit.html>

³ That not only covers the operating cost, funding cost and loan loss provision but also high net margin.

⁴ Compartamos exercise this practice in their every branch.

- b. *Risk management technique*: In case of product design, selecting loan application and follow up, it is important to follow adequate risk management mechanism. Among them, some important techniques are.
- i) *Know your customers (KYC)*: Use due diligence in client screening and assessment of loan application. Clients' repayment capacity, nature of household works or business is needed to consider. Close communication and follow up may increase operating cost, but, to a large extent, it will reduce over-indebtedness.
 - ii) *The amount of credit*: The amount of credit to be sanctioned will be according to repayment capacity of the borrowers. It must not be too low to take multiple loan and not too large for the borrower to afford and repay.
 - iii) *Savings and insurance*: savings and insurance (credit life) can act as buffer against repayment difficulties; reduce borrowers' sacrifice to repay. In this case, commitment device with clients' consent can be an effective tool.
 - iv) *Compliance monitoring and control system*: There need an effective compliance monitoring system inside the MFIs and field level. Random audit, surprise visit and tracking staff can ensure it (Burki, 2009).
 - v) *Set up early warning culture*: Managers should periodically and regularly update all client related information; particularly in monitoring portfolio at risk (PaR), reserve for loan losses and dropout rate that act as the early warning system to take adequate step.
 - vi) *Productive use of loan*: Be sure in productive use of loan by the clients. Consumer loan or use of the loan in unproductive purpose worsens their ability to repay as these loans will not generate any return.
- c. *Avoid aggressive competition and portfolio growth*: Rather than illusive growth, MFIs need to ensure sustainable growth for its long term survival. Rather than expanding in highly competitive saturated market, search for new market/region where poor households actually need financial access and have better potential to spread their operations.

Last, MFIs need to be careful in setting quantity based incentive mechanism by considering portfolio quality and practice of code of conduct. A balanced corporate governance mechanism ensuring key stakeholders' interests that address operating and financing mechanisms of MFIs can overcome some of the problems.

6. 1. 2. For Microfinance Associations, Central Banks, NGO Bureau and Regulators:

- a. *Credit information bureau*: Establish credit information bureau, introduce real time information sharing and update it regularly; ensure that all the MFIs, banks and non-bank financial institutions are using and sharing it so that not any client can take multiple loans. Central bank and regulatory or supervisory authority can ensure it with the help and co-operation from microfinance associations and donors or investors.
- b. *Regulation for MFIs*: Although it is impossible to cover all the MFIs under same umbrella due to their different regulatory status, the state have to be very prudent and careful in forming regulations to ensure microfinance best practices, and to remove all unethical practices (de Quidt et al, 2012).
- c. *Awareness creation and debt literacy*: Introduce debt literacy training and campaign to illiterate poor clients through educational video¹, and media advertisement to create awareness about the proper use of debt and danger of over-indebtedness.

6. 1. 3. For Investors and Donors:

Investors and donors have to be careful and responsible in selecting MFIs when there is rapid growth and strong competition. The funders need to conduct thorough assessment of the MFIs, their operations, and funding proposals with due diligence in the light of client protection principles, management strength, internal control, risk management system and practice of good governance in their operations and management (Leader & Wilson, 2008; Burki, 2009; Gravesteyn et al, 2011).

6. 2. Limitations

The above mentioned recommendations and suggestions have some limitations in their implementation. First, it is almost impossible for the MFIs to ensure productive use of credit by the clients as per the loan agreement. Second, in agrarian economy, when borrowers' income and cash flows are dependent on several external factors that are beyond the control of both parties², the above recommendations may not work in full extent. Third, in some countries, regulation does not permit low cost funding sources such as savings, and hence it is impossible to reduce cost of funds to reduce EAR. Fourth, as claimed in Andhra Pradesh, introduction of credit life insurance goes in opposite direction when the group members and/ or loan officers force the over-indebted

¹ In India Ujjiban do this kind of awareness that is compulsory for every client to see before obtaining loan.

² For example, production fluctuations

clients to commit suicide to recover the loan from insurance company. Fifth, some borrowers deliberately stop repaying, create artificial over-indebtedness, try to politicize and attract media attention and create environment for revolt. Last, when some single mission financial institutions¹ offer consumer credit using same lending methodology of microfinance, it increase competition, cause misunderstanding about microfinance and exacerbate the situation that are beyond the control of MFIs.

Furthermore, implementation of the above mentioned recommendations is not easy. The management of most MFIs may not have adequate financial and risk management background. Dynamic appraisal of clients may be difficult when the clients require quick disbursement.

7. Conclusion

The main objective of this paper is to study whether commercialization of microfinance institutions (MFIs) is responsible for over-indebting their poor borrowers taking into account the Andhra Pradesh crisis. This study argues that we cannot avoid commercialization as subsidized credit and donor support may not exist for a long time and as investors will not provide funds without financial incentives.

Critics argue that massive influx of capital from shareholders, commercial banks, and international and private investors cause exponential growth of loan portfolios and this result in huge market penetration, market saturation, multiple lending, over lending, and finally over-indebting their clients. The diagnosis of Andhra Pradesh incidence indicates that commercialization is not solely and directly responsible for over-indebting their clients. It is the outcome of internal inefficiencies, unethical and malpractices of MFIs and some external factors like production fluctuation and transformation in the agrarian economy in this semi-arid region, and India's long tradition of debt dependency. However, this study found that commercialization is indirectly responsible for over-indebtedness when 'profit seeking', MFIs have driven by commercial investment. It translated into deluge of funds in MFIs, caused huge market penetration, market saturation, and as a result, influenced their management and staffs to follow some unethical practices like multiple lending and over lending, that resulted in over-indebting their clients.

Over-indebtedness, in this case, not only harms the poor clients, but also causes the investors to lose confidence in MFIs when the MFIs loss hope to earn profit, crunch their liquidity, and experience negative growth. It endangers both social and financial missions and the industry sustainability. It makes difficult for the MFIs to find new capital; their share prices in the market fall. Moreover, it not only cause problem to these troubled MFIs, but also spillover in another MFIs, jeopardize the whole industry (Gonzalez, 2008; Wichterich, 2012; Mader, 2013; Schicks, 2013). Over-indebtedness in these problem MFIs put their public reputation in question, accuse political interference, media criticism and ultimately government may take drastic action against them through restrictive regulation.

Proper measure is necessary to overcome such problem and to protect the MFIs and their clients for survival and sustainability of this industry. We should not blame commercialization alone for over indebting microfinance clients. MFIs have to be strict in removing all the malpractices and finding the ways for better welfare of their clients fulfilling their needs on the one hand and for ensuring sustainable growth of the MFIs on the other hand.

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¹ Like banks and non-bank financial institutions.

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